GLOBAL ALPHA

October 3, 2014

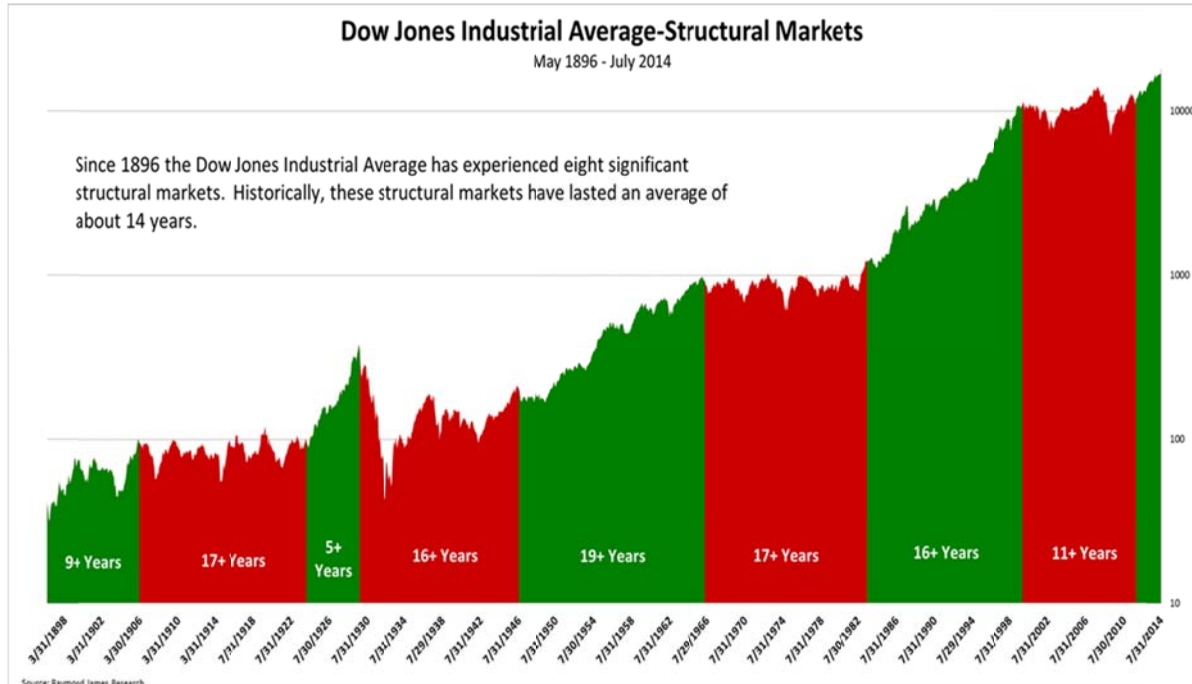
Dear clients and colleagues,

Last few weeks have been difficult for markets, with the S&P down 4% from its peak reached earlier in September. US small cap, emerging markets, Hong Kong, and many other markets are technically in correction (-10% since their peak).

In August, we wrote a comment on our outlook for the markets. The conclusion was that Global economy was improving, led by the US and that quality companies should do well over the long term.

Yesterday, we had the privilege of attending a presentation by Jeffrey Saut, the Chief Investment Strategist of Raymond James, a well-known and respected analyst who has been in the industry since the early 70's and has been a witness of many cycles and bear markets.

The conclusion of Jeffrey's presentation is that we are in a secular bull market. His forecast return until 2020 is 10.5% per year, i.e. 2,842 for the S&P500, and 2% annual dividend. He based his projection on 6.5% annual growth in earnings, which is the average growth since 1989 and a multiple of 15.5x earnings in 2020 which is the current multiple.



Looking at his optimism, markets go up if there is earnings growth. Going back to our comment of August 15th.

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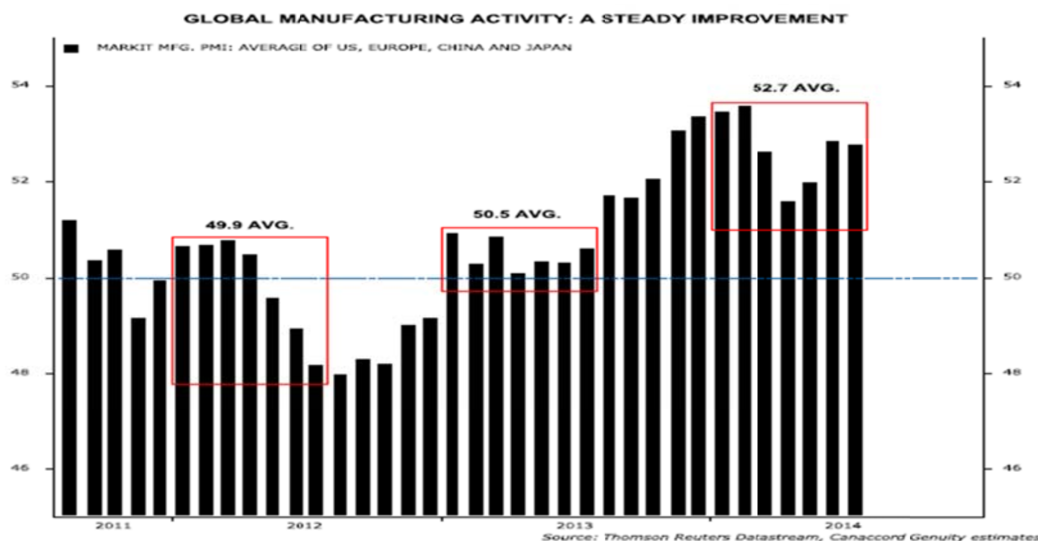
Global manufacturing is improving, jobs are improving, budget deficits are improving, and China is growing. Energy prices are stabilizing and even going down as massive new reserves are discovered, especially in the US.



An interesting quote from Jeff was on the notion of uncertainty. How can markets rise with so much uncertainty? Many people ask.

“The equity markets do not care about the absolutes of good or bad, but rather, are things getting better or worse? “ We agree with Jeff that things are getting better.

This week, we also saw that mergers-and-acquisition (M&A) activity has reached $1.3T this year so far with 7,823 proposed deals, up from $864B last year and $616B in all of 2012. 2014 will see an all-time record with strategic investors more active that private equity and cross-border M&A at record volumes. The trend should continue into 2015 as the amount of capital to be deployed is still over $3T.

Structural changes should also favor equities. Pension funds hold a significant part of their assets in Bonds, a strategy that will hurt when interest rates rise, which we predict within 18 to 24 months. Large institutions like the Japanese Government Fund, the largest sovereign investor in the world with US$1.2T in assets is already reducing its domestic bond holdings from 55% to 40% and increasing its Japanese shares holdings to 20% from 16%.

Last, we have a generation of baby boomers retiring and bonds paying 2% just won’t do it, especially when we can buy a portfolio of quality companies with a dividend yield exceeding 2.5%. And the echo generation that is about to embark in its savings years will not invest in bonds.

Have a good week.

The Global Alpha Team

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